These notes refer to the Finance Act 2010 (c.13) which received Royal Assent on 8 April 2010

FINANCE ACT 2010

EXPLANATORY NOTES

INTRODUCTION

Section 41Schedule 14: Index-Linked Gilt-Edged Securities

Summary

1. Section 41 and Schedule 14 ensure that companies and groups that hold index-linked gilt-edged securities (ILGs) will not be able to benefit from the tax exemption relating to any increase in the carrying value of the ILGs, to the extent that the company or group is not exposed to the inflationary aspect of holding an ILG because of the existence of a linked hedging arrangement.

Details of the Schedule

2. Paragraphs 2 to 5 are consequential amendments. The amendment at paragraph 5(3) is for clarification only.

3. Paragraph 6 inserts new sections 400A, 400B and 400C into the Corporation Tax Act 2009 (CTA).

4. New section 400A of CTA sets out that under certain circumstances an increase to the carrying value of an ILG, by virtue of section 400(2) of CTA, will be reduced.

5. New subsection (1) provides that section 400A of CTA will apply where section 400 of CTA applies in an accounting period and three Conditions (defined in new subsections (2)-(4)) are all met.

6. New subsection (2) is Condition 1. This is that a company (“company A”) is party to a “relevant hedging scheme” at any time in an accounting period. “Relevant hedging scheme” is defined at new subsection (6).

7. New subsection (3) is Condition 2. This is that there is an increase in the Retail Prices Index (RPI) between the two times mentioned in section 400(1) of CTA.

8. New subsection (4) is Condition 3. This is that the index-linked capital return on the security, or a proportion of it, is hedged. “Index-linked capital return” is defined at new subsection (7). “Hedged” is defined at new subsection (8).

9. New subsection (5) sets out that where section 400A of CTA applies, the increase in carrying value between the relevant times made under section 400(1) of CTA will be reduced in line with the proportion of the return that is hedged. Where the return is wholly hedged the increase in carrying value will be reduced to nil.

10. New subsection (6) defines “a relevant hedging scheme” as a scheme that has the purpose, or one of the main purposes, of any party to that scheme as being to secure that the index-linked capital return from the security (or a proportion of it) is hedged. There must, therefore, be an intention at the start to hedge the relevant return from the security (even if the security is not immediately held).

11. New subsection (7) defines the "index-linked capital return" as being so much of the return from the relevant security that would cause an increase in the carrying value of the security over the relevant time (disregarding the operation of section 400 of CTA) and that increase is attributable to an increase in the RPI.

12. New subsection (8) explains the circumstances when the index-linked capital return will be considered to be "hedged". This is where (because of the operation of a swap or otherwise) the return, or a proportion of the return, will not affect the pre-tax economic profit or loss made by the relevant group or company. The concept of "economic profit or loss" is defined in new section 400B of CTA (see paragraph 14).

13. New subsection (9) defines "the relevant group or company" as being company A and any other company that is associated with company A that is also party to the relevant hedging scheme. The phrase "associated with" is defined at new section 400C (see paragraph 19). This subsection also makes it clear that if there is no company other than company A that is party to the relevant hedging scheme then the "relevant group or company" refers solely to company A.

14. New section 400B of CTA defines references to "profits and losses" for the purposes of new section 400A of CTA.

15. New subsection (1) sets out that any reference to an "economic" profit or loss includes profits and losses that are unrealised as well as realised profits and losses.

16. New subsection (2) sets out that the economic profit or loss made by a relevant group is made by the members of the relevant group, when considered together.

17. New subsection (3) deals with calculating the economic profit and loss made by a group of companies when they do not have coterminous year-ends. It sets out that the economic profits and loss made by a group that are to be computed over a period should be computed over that period regardless of whether that period is an accounting period of the member of the group.

18. New subsection (4) sets out that a "pre-tax" economic profit refers to the economic profit without any regard to any profit or loss made as a result of the Corporation Tax Acts.

19. New section 400C of CTA defines the term "associated with" for the purposes of new section 400A of CTA.

20. New subsection (1) sets out that another company ("company B") is associated with company A at any time during an accounting period of company A where any of five conditions is met. These are defined in new subsections (2)-(6).

21. New subsection (2) is the first condition. This is that the financial results of company A and company B meet the "consolidation condition". The "consolidation condition" is defined in subsection (7) (see paragraph 26).

22. New subsection (3) is the second condition. This is that company A and company B are connected. As per new subsection (8), section 466 of CTA applies for the purposes of establishing connection.

23. New subsection (4) is the third condition. This is that company A has a major interest in company B or vice-versa.

24. New subsection (5) is the fourth condition. This is that company A and a third company meet the "consolidation condition" (see paragraph 26) and that third company has a major interest in company B.

25. New subsection (6) is the fifth condition. This is that company A and a third company are connected (see paragraph 27) and that third company has a major interest in company B.

26. New subsection (7) sets out the "consolidation condition". This is that the financial results of any two companies are required to be consolidated into accounts prepared under section 399 of the Companies Act 2006 or, if they are not to be consolidated in such accounts, then this is due to the exemption at section 399(3) of the Companies Act 2006.

27. New subsection (8) sets out that, for the purposes of this section, section 466 of CTA applies for the purposes of establishing connection.

28. Paragraph 9 provides a transitional rule where an adjustment is to be made under section 400(2) of CTA and the earlier time is before 9 December 2009 and the later time is on or after that date. Where this is the case, the company should split the relevant accounting period into two periods; the first being that part that falls up to 9 December 2009 and the second being that part that falls on or after 9 December 2009. The amounts that are brought into account in each period should be calculated on the basis that they are separate periods of account.

Background Note

29. Index-linked gilt-edged securities (ILGs) are securities issued by the Government. They differ from conventional gilts in that both the interest payments and the principal payment are adjusted periodically in line with movements in inflation (as measured by RPI). Consequently, the holder is provided with inflation proofed income.

30. The corporation tax rules for ILGs ensure that their inflation proof quality is not impacted by tax. They achieve this by exempting from tax the adjustment in the accounts carrying value of an ILG to the extent that the adjustment relates to inflation (i.e. movements in RPI).

31. Some companies and groups in the financial sector have entered into avoidance schemes whereby a prima-facie exposure to ILGs is created, thereby triggering the exemption from tax, while ensuring that the exposure to the ILG is fully hedged in the market. The hedge is commonly a derivative, such as a total return swap that effectively eliminates all risk and reward in respect of holding the ILG. This means that while the company or group entering into the scheme remains economically flat, it manages to retain the tax advantage inherent in holding the ILG.

32. The purpose of these new provisions is to ensure that companies and groups undertaking transactions involving ILGs cannot benefit from the tax exemption to the extent that they are not economically exposed to the inflationary aspect because of the existence of a linked hedging arrangement.